

September 30, 2005

**HONORABLE MAYOR AND CITY COUNCIL:**

In accordance with Section 701(F) of the San José City Charter, I hereby transmit to you a report describing the financial status of the City as of the end of the 2004-2005 fiscal year. As specified in the City Charter, the primary focus of the City Manager's Annual Report is a comparison of actual revenue collections and expenditures to projections included in the City's budget.

The Annual Report document is organized into three sections: (1) Letter of Transmittal, (2) General Fund performance, and (3) Special/Capital Fund performance. The Report also includes a number of recommended actions revising both the 2005-2006 Adopted Operating and Capital budgets. These actions also generally fall into three categories: (1) rebudgeting prior year funds for projects not completed last year; (2) reconciling budgeted Beginning Fund Balance amounts in various funds, including the General Fund, with the actual results; and (3) actions recommended to revise the 2005-2006 budget to reflect more up to date information.

This Letter of Transmittal is intended to provide the Council with summary information regarding the contents of the Report. Included is an overview of the 2004-2005 General Fund financial performance; an analysis of the potential impact of that performance on the current year budget; a discussion of the financial status of selected other City funds; and descriptions of recommendations for revisions to the 2005-2006 Adopted Budgets in a number of funds, including the General Fund.

**RECOMMENDATION**

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It is recommended that the City Council:

- Accept the City Manager's Annual Report produced in compliance with City Charter Section 701 (F).
- Approve Appropriation Ordinance and Funding Sources Resolution amendments in various funds as detailed in Section III (Appropriation/Clean-Up Adjustment Actions), of this report.
- Approve temporary position addition actions in the Planning, Building, and Code Enforcement and Parks, Recreation and Neighborhood Services Departments also described in Section III of this document.

## OVERVIEW

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The economic decline that began in 2001 has continued far longer and been more severe than anticipated, and while the steep declines in revenue collections experienced during the first three years of the slowdown appear to have leveled off, we continue to suffer from the affects of a weakened local economy. On an overall basis, our review of 2004-2005 year-end fiscal results confirms that, in spite of enduring the multi-year impacts of the most severe economic downturn experienced in decades, the City of San José remains in a relatively strong financial condition. Although we have faced significant fiscal challenges for four consecutive years, we can be very proud of the fact that we have survived these difficulties without suffering the type of severe impacts seen in some other local governments around the State and country. We have avoided having to lay off City employees, and our core services remain intact, although often at a reduced level. We are especially proud to report that the General Fund not only ended yet another tough year in the black, but also closed the year with a small surplus over the budgeted ending fund balance estimate for the General Fund.

This is not to say that the actions necessary to remain fiscally sound have come without a cost to the organization and to the service levels experienced by our citizens. While we may have been able to place all impacted employees in alternate positions through aggressive maintenance of a hiring freeze now entering a fifth year, many crucial City positions have been lost, and important City services have been severely impacted or eliminated. It is the City Council's commitment and continued adherence to its long held conservative fiscal policies that have guided this City through good times and bad, and despite one of the worst economic downturns in the last several decades, have led the City to make the tough decisions necessary to remain fiscally sound. As an indication of the success of these policies, the City remains well regarded by those agencies whose job it is to rate City financial conditions, with San José continuing to receive a strong AA+ bond rating, the highest of any major California city, through the sustained downturn.

Although the review of the fiscal performance outlined in this report makes clear that for a fourth straight year the City suffered from a stagnant economy, we have experienced some good news. General Sales Tax quarterly receipts have resumed modest growth, experiencing small increases over the last five quarters, after dropping for ten consecutive quarters. Transient Occupancy Tax receipts are also experiencing growth after several years of falling collections. Other economically sensitive revenues are flat. Prospects for the national and State economies remain uncertain. The recent fall in consumer confidence indicators is a sign of the nervousness that exists nationally over the impact of such factors as skyrocketing energy prices, the unsettled situation in Iraq, and the impacts of the recent hurricanes in the Gulf Coast states. It is our overall assessment that there are no tangible signs that a significant improvement in the City's fiscal situation is near, and, as a result, the City needs to prepare for the likelihood that the next several budgets will require not only continued fiscal restraint, but the probability of more significant and painful fiscal actions.

## **OVERVIEW (CONT'D.)**

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In the General Fund, the City ended the 2004-2005 year as well as it did due to aggressive cost containment strategies, including mid-year budget reductions, and accurate revenue estimating. On the expenditure side of the equation, aggressive cost saving measures were imposed all during the year. The hiring freeze (first imposed in 2001) was continued throughout the 2004-2005 fiscal year, departmental Cost/Position Management plans were required from all departments for a fourth year in a row, resulting in mid-year budget reductions totaling \$5.2 million in the General Fund to be placed in a previously created reserve for 2005-2006 budget balancing purposes. Approval of that action brought the total in that 2005-2006 reserve to \$12.5 million, which was used to help balance the 2005-2006 General Fund budget. Additional controls were also continued on a number of non-essential expenditure categories, including those related to overtime, travel, marketing, and technology purchases. In total, although General Fund expenditures grew by 1.7%, on a gross basis year-end savings of \$35.0 million were achieved above fund balance estimates. After adjusting for grant and reimbursement related appropriations not expended in 2004-2005, but rebudgeted to 2005-2006, expenditures ended the year very close to estimated levels, as adjusted savings were approximately \$14.2 million under budgeted fund balance estimates.

On the revenue side of the General Fund, as always, receipts were closely monitored and reported to the City Council through the Monthly Financial Reporting process and the Mid-Year Budget Review. In 2004-2005 overall General Fund revenues grew by \$33.2 million or 5.1% from the prior year. In addition to the higher Sales Tax and Transient Occupancy Tax revenues previously discussed, the growth in revenues was also due in large part to more than \$9.0 million received for the first time from the implementation of the new Emergency Communications System Support Fee (ECSS Fee). The amount of revenue collected in the ECSS Fee Fund (\$9.1 million) that was transferred to the General Fund to reimburse related expenditures, was, however, slightly under the \$9.4 million modified budget level. This source will be closely monitored and the performance will be reported through the 2005-2006 Monthly Financial Report process.

As a result of the active management of our revenue estimates, the General Fund in 2004-2005 ended the year very close to the projected total, finishing on a gross basis just \$6.0 million below the budgeted estimate. After adjusting for grant and reimbursement related revenues not received in 2004-2005, but carried over to 2005-2006, it can be seen that revenues actually ended the year within 2.2% or \$14.8 million above the budgeted estimate used for fund balance purposes. Given our stated desire to end the year slightly (1%-2% above budgeted levels), the Administration considers this performance to be a remarkable accomplishment given the total size of General Fund revenues (over \$682 million).

The overall result of this performance was a General Fund that ended the year in a positive position, with a fund balance surplus (from the budget) of \$30.3 million (prior to rebudgets and other adjustments), the components of which are explained in greater detail later in this transmittal.

## **OVERVIEW (CONT'D.)**

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In summary, for 2004-2005, we believe our policy choices and management strategies implemented to preserve the fiscal soundness of the City in the face of the very tough fiscal climate were highly successful. Our forecasts unfortunately indicate that we will need to continue to pursue such efforts, as it is clear that additional tough times lay ahead. Accordingly, and in keeping with City Council policy, contained in this report is a recommendation to use all the surplus General Fund fund balance monies left after rebudgeting and recommended clean-up actions (\$12.5 million) to establish a 2006-2007 Future Deficit Reserve.

## **2004-2005 GENERAL FUND PERFORMANCE OVERVIEW**

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As discussed above, the analysis of final 2004-2005 year-end financial data indicates that the City ended the year close, but above the level projected, and well within budget. As a result of this performance, the 2004-2005 General Fund Ending Fund Balance of \$166.1 million was approximately \$30.3 million above the fund balance level estimate approved as part of the 2005-2006 Adopted Budget.

Table 1 (below) describes the three principal components of the \$30.3 million fund balance surplus. On a gross basis, the surplus amount was composed of \$1.5 million in higher than anticipated liquidation of carryover encumbrances, a \$6.0 million shortfall in revenue collections, and \$35.0 million in additional expenditures/transfers savings. It should be noted that after adjusting for net zero grant and reimbursement related revenues and expenditures not received or expended in 2004-2005, but carried over to 2005-2006, a more accurate depiction of the revenue variance is a surplus of \$14.8 million and the expenditures variance, as adjusted, is a surplus of \$14.2 million.

A significant portion of additional fund balance is recommended to be reinvested as a part of this report: \$7.3 million is recommend to be rebudgeted to complete various projects, and/or clean-up problems discovered since the approval of the 2005-2006 budget. Under our current policy, a total of \$2.4 million in Development Program fee proceeds needs to be placed in the existing Fee Program reserves as a result of the year-end reconciliation process comparing revenues and expenditures. A total of \$8.1 million is recommended to be used for various required adjustments to address mistakes discovered in the 2005-2006 Budget since it was adopted, and/or additional funding needs that have arisen since the June approval of the budget. Finally, as noted above, the surplus fund balance monies left after rebudgeting and recommended clean-up actions (\$12.5 million) are recommended to be used to establish a 2006-2007 Future Deficit Reserve. The specific adjustments proposed are discussed in greater detail later in this transmittal and elsewhere in this document.

**2004-2005 GENERAL FUND PERFORMANCE OVERVIEW (CONT'D.)**

**Table 1**  
**Results of Operations in the General Fund**  
**For the Year Ended June 30, 2005**  
**(\$000's)**

<i>Sources</i>	<b>1</b> <b>Revised</b> <b>Budget</b>	<b>2</b> <b>Year-end</b> <b>Estimate</b>	<b>3</b> <b>Budgetary</b> <b>Basis</b> <b>Actual</b>	<b>4</b> <b>Variance</b> <b>1 to 3</b>	<b>5</b> <b>Variance</b> <b>2 to 3</b>
<i>Beginning</i> <i>Fund Balance</i>	174,119	174,119	174,119	-	-
<i>Liquidation of Carry-</i> <i>over Encumbrances</i>	-	1,000	2,489	2,489	1,489
<i>* Revenue</i>	688,053	688,053	682,028	(6,025)	(6,025)
<i>Totals</i>	<u>862,172</u>	<u>863,172</u>	<u>858,636</u>	<u>(3,536)</u>	<u>(4,536)</u>
<i>Uses</i>					
<i>* Expenditures</i>	752,241	721,444	686,407	65,834	35,037
<i>Transfers</i>	6,157	6,157	6,157	-	-
<i>Reserves</i>	103,774	(184)	-	103,774	(184)
<i>Totals</i>	<u>862,172</u>	<u>727,417</u>	<u>692,564</u>	<u>169,608</u>	<u>34,853</u>
<i>Available Ending</i> <i>Fund Balance</i>	<u>N/A</u>	<u>135,755</u>	<u>166,072</u>	<u>166,072</u>	<u>30,317</u>

- After adjusting for a net-zero \$20.8 million of grant and reimbursement related revenues and expenditures not received or expended in 2004-2005, but carried over to 2005-2006, the revenue variance resulted in a surplus of \$14.8 million and the expenditures variance actually totaled \$14.2 million.

• **2004-2005 GENERAL FUND PERFORMANCE OVERVIEW (CONT'D.)**

Table 2 below compares the City's financial performance in 2004-2005, with the financial performance of the prior year (2003-2004).

**Table 2**  
**General Fund**  
**Comparison of Year-End Actuals With Prior Year**  
**(\$ in millions)**

<i>Sources</i>	<b>2003-2004</b>	<b>2004-2005</b>	<b>Change</b>	<b>% Change</b>
<i>Beginning Fund Balance</i>	185.8	176.6	(9.2)	(5.0%)
<i>Revenue</i>	648.8	682.0	33.2	5.1%
<i>Total Source</i>	834.6	858.6	24.0	2.9%
<i>Uses</i>				
<i>Expenditures</i>	674.6	686.4	11.8	1.7%
<i>Transfers</i>	6.6	6.1	(0.5)	(7.6%)
<i>Total Use</i>	681.2	692.5	11.3	1.7%
<i>Available Ending Fund Balance</i>	153.4	166.1	12.7	8.3%

As shown in Table 2, 2004-2005 General Fund revenues of \$682.0 million represented an increase (5.1% or \$33.2 million) from the prior year's collection level. The increase from the prior year reflected the combined performance of General Fund revenue categories. Decreases from the prior year level were experienced in a number of sources: Fines, Forfeitures, and Penalties, down 3.9%; Use of Money and Property, down 4.4%; Revenue from the State of California, down 70.9%; Revenue from the Federal Government, down 10.8%; and Transfers and Reimbursements, down 1.1%. These declines were more than offset, however, by higher receipts in the remaining revenue categories: Property Tax, up 50.6%; Sales Tax, up 1.8%; Transient Occupancy Tax, up 12.2%; Franchise Fees, up 6.3%; Utility Tax, up 6.8%; Licenses and Permits, up 5.1%; Revenue from Local Agencies, up 7.6%; Departmental Charges, up 2.7%; and Other Revenue, up 16.5%.

General Fund expenditures of \$692.5 million increased 1.7% (\$11.3 million) when compared to the prior year expenditure level of \$681.2 million, reflecting both the reductions in the budget approved for 2004-2005 and the savings achieved by the strong efforts adopted by the City to contain costs to the extent possible in the face of relatively flat revenues.

## 2004-2005 GENERAL FUND PERFORMANCE OVERVIEW (CONT'D.)

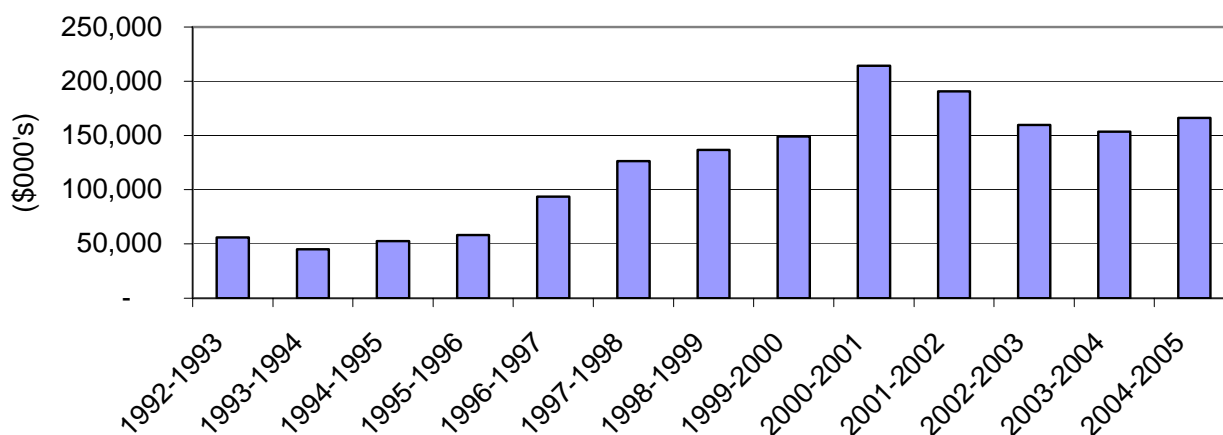
However, it is worth noting that even with extensive expenditure reductions reflected in the 2004-2005 budget, and a concerted effort to keep costs down during the year, personal services expenditures still grew by 2.5% or \$12.2 million over the prior year (Table 3).

**Table 3**  
**General Fund**  
**Comparison of Year-End Actuals With Prior Year By Expenditure Category**  
**(\$000's)**

Category	2004-2005 Actual	2003-2004 Actual	Variance	% Variance
<i>Personal Services</i>	497,637	485,475	12,162	2.5%
<i>Non-Personal/Equipment/Other</i>	81,779	84,790	(3,011)	(3.6%)
<i>City-Wide Expenses</i>	88,369	86,528	1,841	2.1%
<i>Capital Contributions</i>	18,622	17,824	798	4.5%
<i>Transfers</i>	6,157	6,559	(402)	(6.1%)
<i>Reserves</i>	-	-	-	N/A
<b>TOTAL GENERAL FUND</b>	<b>692,564</b>	<b>681,176</b>	<b>11,388</b>	<b>1.7%</b>

As a result of our efforts to keep costs down and explore all revenue options, the year ended with a small (\$12.7 million) increase in the overall 2004-2005 Available Ending Fund Balance (\$166.1 million) when compared to the prior year (\$153.4 million). This is extremely welcome news as this increase breaks a string of four straight years of declines in ending fund balances. Although these decreases were planned as part of previous budget balancing strategies, the last four years are put into perspective when it is noted that a net annual decrease in the size of the General Fund's ending fund balance had happened only once in the decade before the fund balance declines began in 2001-2002.

**General Fund**  
**Fund Balance History**



## **ANALYSIS OF 2004-2005 GENERAL FUND OPERATIONS**

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The following is a summary discussion by category of how the various components of the General Fund budget performed in 2004-2005. A more detailed explanation of the activities in each of these categories can be found later in this document.

### **Sources of Funds**

Overall General Fund sources of funding (revenue plus fund balance) ended the year \$3.5 million (0.41%) below the 2004-2005 Modified Budget level, and \$4.5 million (0.53%) below the estimate used to develop the 2005-2006 Adopted Budget's Beginning Fund Balance component.

On a gross basis, total General Fund revenue collections of \$682.0 million ended the year less than one percent (0.9% or \$6.0 million) below the 2004-2005 Modified Budget level. After adjusting for grant and reimbursement related revenues that were carried over to 2005-2006, however, revenue actually ended the year slightly above (2.2% or \$14.8 million) the modified budget level. As described above, this performance was the cumulative result of a number of higher and lower than budgeted revenue source performances. It should be noted that one area that was carefully monitored in 2004-2005, and that we will need to continue to monitor in 2005-2006, is the continuing impact of prior State budget balancing actions on our revenue sources. Based on recent information, one action in particular will negatively impact the 2005-2006 Adopted Budget. As reported in the Monthly Financial Reports during 2004-2005, the impact of the State action known as the Triple-Flip resulted in 25% of the City's sales tax receipts being converted to in-lieu payments and included as part of the City's property tax receipts. According to information received from the State last Spring, the in-lieu payments in 2004-2005 were based on estimates, but any difference was to be "trued-up", or reconciled, in the following year. The State has, however, recently released the amount of the true-ups, and, based on calculations that do not conform to the intent originally expressed, and are more favorable to the State, the City determined that the in-lieu payments to be received in January 2006 and May 2006 will be reduced by \$4.2 million from what we had been led to believe would be the case. It is our position that the methodology being used by the State does not conform to the expressed intent to hold local governments harmless. We will work with our State representative and local legislative representatives to make this case and try and effect a change in the methodology currently being proposed by the State.

A net adjustment of approximately \$2.4 million to the various Development Fee Program Reserves is recommended as part of this report to adjust the reserves to the amounts actually generated by various Fee Programs per our commitment to the local development community. Net of revenues and expenditures, an adjustment of \$2.0 million is recommended for placement in the Planning and Building Fee Program Reserves; \$317,000 is recommended to be reduced from the Public Works Fee Program Reserve; and \$785,000 in the Fire Fee Program Reserve. These actions are consistent with the budget policy enacted several years ago, preserving any expenditure savings or revenue excess in these fee programs in reserves dedicated to that purpose.



## **ANALYSIS OF 2004-2005 GENERAL FUND OPERATIONS (CONT'D.)**

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### **Uses of Funds**

Overall, on a gross basis, General Fund uses of funds ended the year \$169.6 million under (down 19.7%) the 2004-2005 Modified Budget level, and \$34.9 million below (down 4.8%) the estimate used to formulate the 2005-2006 Adopted Budget's Beginning Fund Balance component. Most of the savings total, approximately \$134.7 million, was previously estimated to be available by year-end as part of the beginning fund balance estimate that was included in the 2005-2006 Adopted Operating Budget. The net additional savings in this category was \$34.9 million, but again, adjusting for previously discussed grant and reimbursement related appropriations that were rebudgeted to 2005-2006, expenditures savings actually ended the year \$14.2 million above the budgeted estimate.

As is the standard practice in these Annual Reports, the recommitment of funding through rebudgeting actions is recommended as part of this report to fund uncompleted projects and to allocate development-related expenditure savings to the appropriate development-related activities. A more detailed discussion of the significant specific rebudget amounts is provided in the General Fund Expenditure Performance section found later in this document. After accounting for these additional recommended rebudgets, including reserves, net savings of approximately \$12.5 million was realized, primarily from personal services, non-personal/equipment, and capital project savings.

The 2004-2005 General Fund Contingency Reserve ended the year at \$24.9 million. This was 12.2% above (\$2.7 million) the 2003-2004 year-end level of \$22.2 million, and met the Council policy goal of being at least 3.0% of total budgeted General Fund expenditures (excluding encumbrances, the Contingency Reserve, and the Workers' Compensation Reserve). At the beginning of each year, the Contingency Reserve is established at a level necessary to meet or exceed the City Council's reserve policy level of 3.0% of expenditures. During the year, however, the reserve level can sometimes drop below 3.0% if significant additions to the budget or uses of the Contingency Reserve are approved.

### **Ending Fund Balance**

The current budgeting practice of the City is to use the fund balance remaining in the General Fund at the end of any fiscal year, after the establishment of sufficient funding in the Contingency Reserve, as a funding source for the following year. Thus, each year during the budget process, a detailed estimate of the unused balance in the General Fund is incorporated into the Adopted Budget.

The Ending Fund Balance estimate always contains two components: the portion of the fund balance that needs to be rebudgeted for completing projects or retaining reserves; and that portion which is truly undesignated and available as a general funding source in the coming year. The undesignated portion is further divided into ongoing and one-time components to assure that the City does not fund ongoing programs with one-time fund balance monies. The components of ending fund balance in any year are unexpended reserves, expenditure/transfer savings, excess revenue, and liquidated encumbrances.

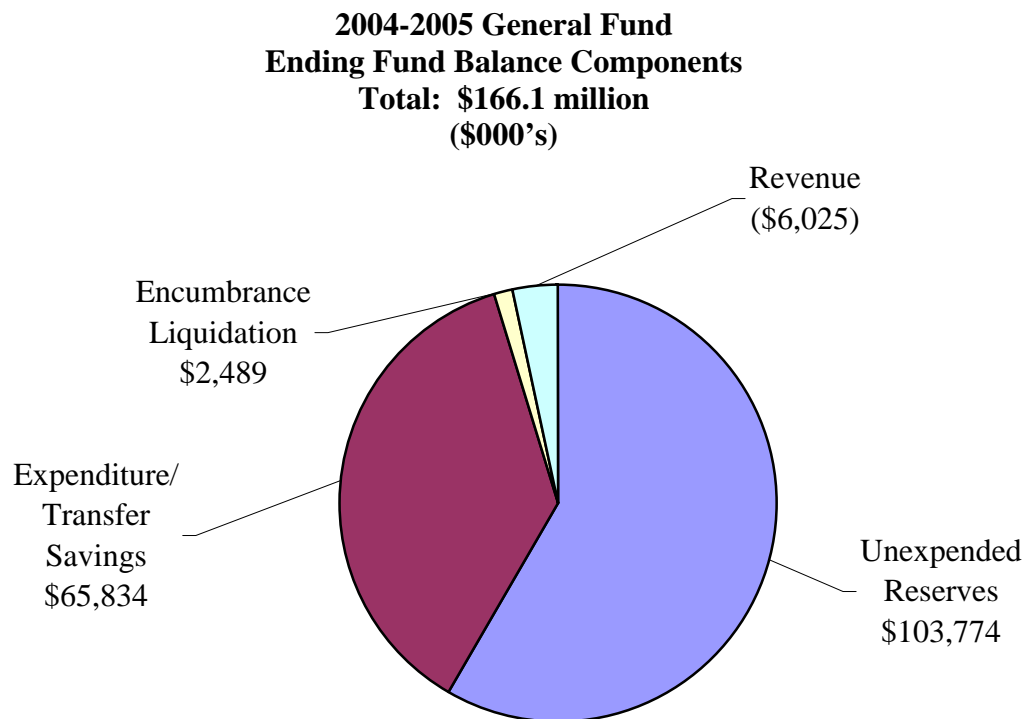
## ANALYSIS OF 2004-2005 GENERAL FUND OPERATIONS (CONT'D.)

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### Ending Fund Balance (Cont'd.)

When the 2005-2006 Operating Budget was developed, it was estimated that the 2004-2005 ending fund balance would total approximately \$135.8 million. As discussed earlier, the actual ending fund balance of \$166.1 million was \$30.3 million above that estimated level, and \$12.7 million above the prior year level. This growth ends four straight years of reduced fund balances, but it would be prudent to remember that during the past four years, as part of a deliberate strategy to minimize the impact on service delivery, the City used more than \$60 million of fund balance it had accumulated over the flush years of the late 1990s. In fact, even with the \$12.7 million increase this year in ending fund balance, the City's fund balance is still more than \$48.0 lower than it was in 2000-2001. This is both a reminder of the very different and difficult financial environment the City is now operating in, and an indication of how important it is for us to continue to follow the cautious financial strategy recommended in this report concerning the commitment of any additional one-time funding that becomes available.

The components of the 2004-2005 General Fund Ending Fund Balance are described below:



- As planned, the largest component of the Ending Fund Balance, unexpended reserves, totaled \$103.8 million, which represents the Contingency Reserve (\$24.9 million), Earmarked Reserves (\$66.9 million), and Ending Fund Balance Reserve (\$12.0 million). The most significant components of the Earmarked Reserves were the following: 2005-2006 Future Deficit Reserve (\$12.5 million); Development-Related Activities Reserves (\$11.1 million); Economic Uncertainty Reserve (\$10.4 million); Workers' Compensation Reserve (\$10.0 million); Enhanced Park Maintenance Reserve (\$6.3 million); and Future Capital Projects

## **ANALYSIS OF 2004-2005 GENERAL FUND OPERATIONS (CONT'D.)**

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### **Ending Fund Balance (Cont'd.)**

(FF&E) Reserve (\$5.2 million). The Ending Fund Balance Reserve of \$12.0 million was assumed as available for allocation as part of the 2005-2006 Available Beginning Fund Balance.

- Expenditure/Transfer savings totaled \$65.8 million. After adjusting for grant and reimbursement related expenditures that were rebudgeted to 2005-2006 (\$20.8 million), however, expenditures actually ended the year at \$45.0 million below the modified budget level. (A corresponding revenue shortfall was also realized and carried over to 2005-2006 for a net zero impact on the General Fund.) A large portion of these savings (\$28.8 million), were rebudgeted as part of the 2005-2006 Adopted Budget for completion of 2004-2005 programs. Additional expenditure/transfer rebudgets and technical adjustments totaling \$9.7 million are recommended as part of this report.
- Total revenues plus fund balance resulted in a shortfall of \$6.0 million. After adjusting for grant and reimbursement related revenues that were carried over to 2005-2006 (\$20.8 million), however, revenue actually ended the year slightly above (2.2% or \$14.8 million) the modified budget level. (As discussed above, corresponding expenditure savings were also achieved and rebudgeted to 2005-2006 for a net zero impact on the General Fund.)
- The final component of the Ending Fund Balance is the value of the liquidation of carryover encumbrances, which in 2004-2005 totaled \$2.5 million. Actual liquidations ended the year above the \$1.0 million level assumed in the 2004-2005 Adopted Budget.

## **IMPACTS ON THE 2005-2006 ADOPTED BUDGET**

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### **Beginning Fund Balance**

With the City's current budget practice, ending fund balance amounts carried into the next fiscal year as beginning fund balance is a significant source of one-time funding for the budget. As described previously, the actual General Fund ending balance was above the estimate used in the 2004-2005 Adopted Budget by \$30.3 million. Including Earmarked Reserves, a total of \$17.8 million of this amount is recommended to be rebudgeted and/or utilized to correct problems discovered with the Adopted Budget (described in more detail below). Per City Council policy, the remaining \$12.5 million is recommended to be allocated to a 2006-2007 Future Deficit Reserve.

The following chart details the recommendation included in this document for use of the \$30.3 million additional fund balance:

## IMPACTS ON THE 2005-2006 ADOPTED BUDGET (CONT'D.)

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### Beginning Fund Balance (Cont'd.)

#### PROPOSED ALLOCATION OF ADDITIONAL FUND BALANCE (\$000s)

<b>Fund Balance Variance</b>	<b>\$ 30,317</b>
Changes to Fee Reserves	2,449
Rebudgets/Technical Adjustments	7,324
Required/Recommended Current Year Adjustments	8,091
2006-2007 Future Deficit Reserve	12,453
<b>Fund Balance After Recommended Adjustments</b>	<b>\$ 0</b>

- **Changes to Fee Reserves (\$2.4 million)** – Consistent with the budget policy enacted several years ago and our commitment to the development community, a net \$2.4 million is recommended to be added to the Development Program Fee Reserves (Building, Planning, Fire, and Public Works), preserving all expenditure savings and/or revenue excess in these programs. In addition, as part of this report, an augmentation is proposed to the Building Fee program to help retain our ability to meet development service performance targets and customer service needs in 2005-2006. The recommended adjustment includes the addition of one temporary Planner position and related non-personal/equipment. This addition is recommended to be offset by a corresponding reduction to the existing earmarked reserve for building development-related activities.
- **Rebudgets/Technical Adjustments (\$7.3 million)** – As discussed above, this series of adjustments are recommended to complete existing projects in 2005-2006 and to reflect any necessary technical budget adjustments. The Annual Report is the point in the budget process where action is required to provide for the rebudgeting of year-end savings not anticipated when the Adopted Budget was approved, but required to complete a significant City Council approved project. Also recommended are a few actions that actually reduce previous rebudgets in various departments' Capital, and the City-Wide Expenses category, to reflect instances where greater than expected expenditures occurred in 2004-2005 and previously rebudgeted funds are, therefore, not needed in the current year. A net total of \$7.3 million of Rebudgets/Technical Adjustments are identified in this report that need to be carried to the 2005-2006 fiscal year in order to complete the specific projects and programs. The two largest components of this rebudget/technical adjustment recommendation are a transfer of excess Construction and Conveyance Tax revenue to the Park Maintenance Reserve (\$1.7 million) as required by current Council policy; and General Fund City-Wide Expenses (\$3.8 million).
- **Required/Recommended Current Year Adjustments (\$8.1 million)** – A number of General Fund budget additions and reductions are recommended to address current year funding needs that have emerged since the 2005-2006 budget was approved. The following augmentations are recommended and explained in more detail elsewhere in this document:

## **IMPACTS ON THE 2005-2006 ADOPTED BUDGET (CONT'D.)**

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### **Beginning Fund Balance (Cont'd.)**

- the provision of funding for additional testing and potential site remediation for Watson Park and to reimburse Council District #3 for prior year expenditures (\$2.9 million);
- the provision of funds for litigation settlement of a wrongful death lawsuit (\$1.2 million);
- the provision of additional funding to be distributed to the primary departmental consumers of fuel due to the volatility of fuel prices (\$1.0 million);
- a return to the Contingency Reserve of funding that was approved by the Council on September 20 to provide help to Hurricane Katrina victims (\$500,000);
- additional funding for the Municipal Golf Course Fund to fill the expected gap between golf course earnings and debt service requirements (\$500,000);
- the provision of funds for retrofit/replacement of the Convention Facility Marquee (\$400,000);
- funding for the delay in implementing a 2005-2006 Adopted Budget action that selectively turns off streetlights in industrial and commercial areas (\$320,000);
- funding for long-range planning efforts (\$250,000);
- funding to pay for additional costs for a special election in Council District 7 (\$200,000);
- funding for a transfer from the General Fund to the Muni Water Fund to reflect actual rate of return calculations that were less than the original estimate included in the Adopted 2004-2005 Budget (\$153,000);
- a technical adjustment to appropriate reimbursable Special Assessment District related activities in the Public Works Department (\$150,000);
- funding for election commission investigative services (\$150,000);
- funding to provide Service Yard custodial services that have been determined by the Attorney's Office to no longer be eligible for Construction and Conveyance tax funding (\$137,000);
- a technical adjustment to appropriate reimbursable Convention Facility oversight activities (\$82,000);
- additional funding for the Public Works Department Non-Fee Program compensated absences (\$70,000);
- a technical adjustment to provide funding to the Public Works Department for transportation fee activities (\$60,000);
- funding to the Office of Cultural Affairs to provide new lights for the Montgomery Theater (\$24,000);
- a transfer to the Gift Trust Fund to reconcile fund balances (\$18,000);
- a technical adjustment to correctly budget the San Jose Stage allocation (\$1,000);
- and four net-zero adjustments to reflect the revenues and expenditures for a SJ LEARNS Grant (\$948,000), a temporary Marketing/Public Outreach Representative for Happy Hollow (93,000), a Science Grant (\$13,000), and an ICMA Grant (\$5,000).

## IMPACTS ON THE 2005-2006 ADOPTED BUDGET (CONT'D.)

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### Beginning Fund Balance (Cont'd.)

- **2005-2006 Future Deficit Reserve (\$12.5 million)** – After the above actions, per City Council policy, the remaining \$12.5 million in unallocated funds is recommended to be used to establish a 2006-2007 Future Deficit Reserve. Doing so will help prepare the organization to address what will again surely prove to be a challenging, upcoming budget year. The recommended reserve is consistent with the fiscally conservative approach that has served the City so well up to this point.

### Additional Adjustments to the 2005-2006 Adopted Budget

In addition to the previously discussed recommended uses for the surplus fund balance, a number of other revenue-related adjustments and reallocations are proposed as a part of this report.

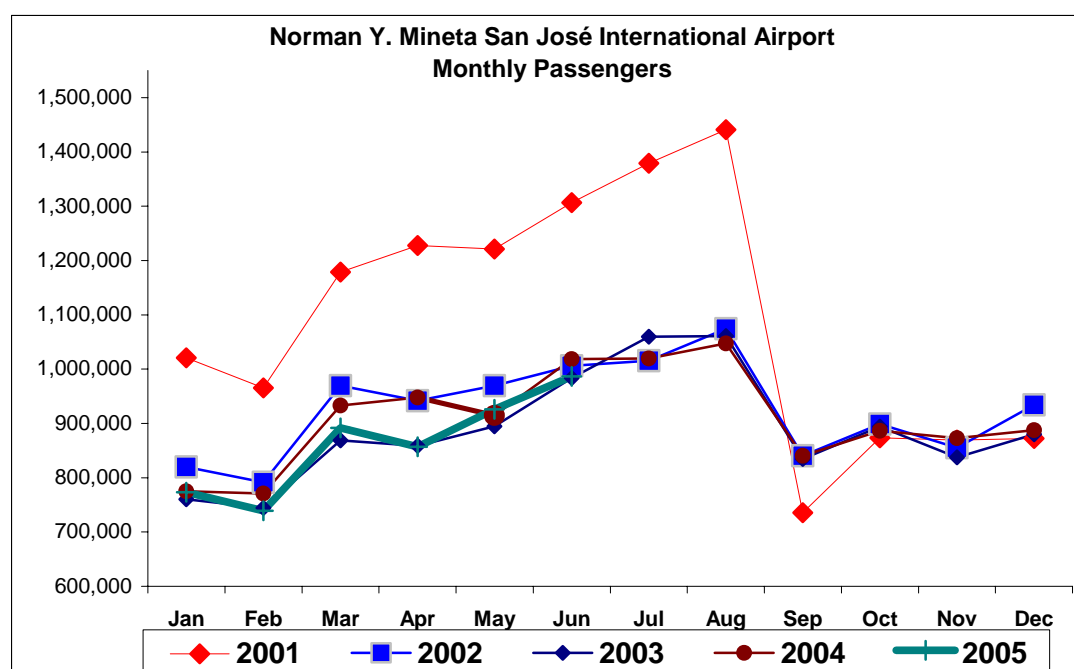
- **Revenue-Related (\$3.1 million)** – Generally, this category of adjustments rebudget the revenue and corresponding expenditure budget for various grants to 2005-2006, including the following: Evergreen Smart Growth (\$2,181,000), Coyote Valley Specific Plan (\$48,000), various Public Safety grants (\$121,000), and miscellaneous literacy activity grants (\$447,000).
- **Reallocations** – This category of recommended actions redistributes funds to reflect the appropriate placement of funding for approved budget actions. The largest portion of funding movement that falls into this category are the reallocation of two earmarked reserves, Hayes Mansion Debt Service and Fuel Usage, to active appropriations. An earmarked reserve was established in the 2005-2006 Adopted Operating Budget to subsidize a portion of the required debt service payments for the Hayes Mansion if revenues in the Community Facilities Revenue Fund were not sufficient to cover all of the debt service requirements. Although there is some improvement in revenues for 2005-2006, compared to 2004-2005, revenue performance will not occur at a level sufficient to fully cover operating expenses plus debt service on the Hayes Mansion bonds. A Fuel Usage earmarked reserve was established in the 2005-2006 Adopted Operating Budget due to the volatility in the market for fuel. In addition to the recommended liquidation of this reserve, additional funding in the amount of \$1.0 million is recommended in this report to be distributed to the primary consumers of fuel.

## STATUS OF SPECIAL/CAPITAL FUNDS

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### Airport Operating Funds

Airport passenger activity decreased .2%, a decrease of 24,128 passengers during 2004-2005 compared to the prior year. New service at the Airport during the year included the May 2005 introduction of Independence Air to San José, with a daily non-stop flight to Washington Dulles Airport. Also in May, JetBlue Airlines initiated direct flight service to Boston and Southwest Airlines added a daily, direct flight to Chicago. Traffic operations and landed weights paralleled the slight decline in passenger activity.



Overall, Airport operating revenues were slightly below budgeted levels, but were within 1% of estimates. Airfield, Parking and Roadway and Concession revenues exceeded estimates, Terminal Rentals met estimates and finally Landing Fees and General and Non-Aviation revenues ended the year slightly under estimates. In order to meet the challenge posed by limited revenues and the need to maintain customer service levels, the Airport continued its practice of setting service priorities, savings targets and closely monitoring all expenditures. The Airport Department set a target to save a total of \$3.8 million in direct personal services and non-personal/equipment expenses during 2004-2005. By the end of the fiscal year, the savings target was met and exceeded by over \$1.3 million. In addition, conservative management of transfers, reserves and contingencies and prior year liquidations provided an additional \$5 million in operating savings. These actions contributed to higher than anticipated fund balances present in Airport funds at year-end.

## **STATUS OF SPECIAL/CAPITAL FUNDS (CONT'D.)**

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### **Convention and Cultural Affairs Fund**

The Convention and Cultural Affairs Fund accounts for the operation of the Convention Facility that is managed by Team San Jose. In 2004-2005, activity at the Convention Center did not generate anticipated revenues. Actual revenue collections were \$2.4 million below the budgeted level due to lower than anticipated space rental and concessionary income (\$2.1 million) and parking fees (\$332,000). It should be noted that the parking fee shortfall is overstated by \$148,000 due to a booking error that will be corrected as part of this report.

The revenue shortfall was partially offset by expenditure savings of approximately \$600,000 that were generated from vacancy savings and lower non-personal/equipment expenditures. Almost all of the 2004-2005 combined revenue shortfall and expenditure savings was assumed in the development of the 2005-2006 Adopted Budget. As a result, the actual 2004-2005 ending fund balance in this fund was only \$309,000 below the estimate used in the 2005-2006 Adopted Budget. This shortfall will be offset by additional revenue from the Transient Occupancy Tax Fund based on higher Transient Occupancy Tax collections in 2004-2005 (\$170,000) and a transfer from the General Purpose Parking Fund to fully account for parking fees earned in 2004-2005 (\$148,000).

### **Municipal Golf Course Fund**

The Municipal Golf Course Fund accounts for the operation of three City-owned golf courses: San Jose Municipal, Los Lagos, and Rancho del Pueblo. This fund performed as anticipated in 2004-2005 requiring a General Fund subsidy of \$650,000. While this fund ended the year within estimated levels, it is anticipated that it will require an increase in the General Fund subsidy from the currently budgeted \$750,000 to \$1.25 million in 2005-2006. After the 2005-2006 budget was developed, it was determined that the funding for debt service payments programmed in 2005-2006 is insufficient by approximately \$300,000. In addition, the 2005-2006 revenue estimate of \$850,000 for the Los Lagos Golf Course may be too aggressive based on the actual revenue collections of \$650,000 in 2004-2005. Given these factors, an additional transfer of \$500,000 from the General Fund is recommended in this report to ensure the fund is able to meet all of its financial obligations in 2005-2006.

### **Transient Occupancy Tax Fund**

Due to higher than expected receipts in the last half of the year, revenues in the Transient Occupancy Tax Fund exceeded the budgeted amount by \$717,000. Although the average hotel occupancy rate for the City remained approximately the same as last year (48.8%); the average room rate went up from \$110.69 to \$114.06, as did the number of rentable room nights, which went up about 7.6%.

Transient Occupancy Tax Fund tax revenue is by ordinance shared by three groups, the Convention Center Operation Subsidy (50%), the Convention Visitors Bureau (25%) and Cultural Grants (25%). This report, therefore, contains the proposed appropriation adjustment actions required to distribute the excess collections to the three groups, (net of funds rebudgeted as part of the 2005-2006 Adopted Budget).



## STATUS OF SPECIAL/CAPITAL FUNDS (CONT'D.)

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### Transient Occupancy Tax Fund (Cont'd.)

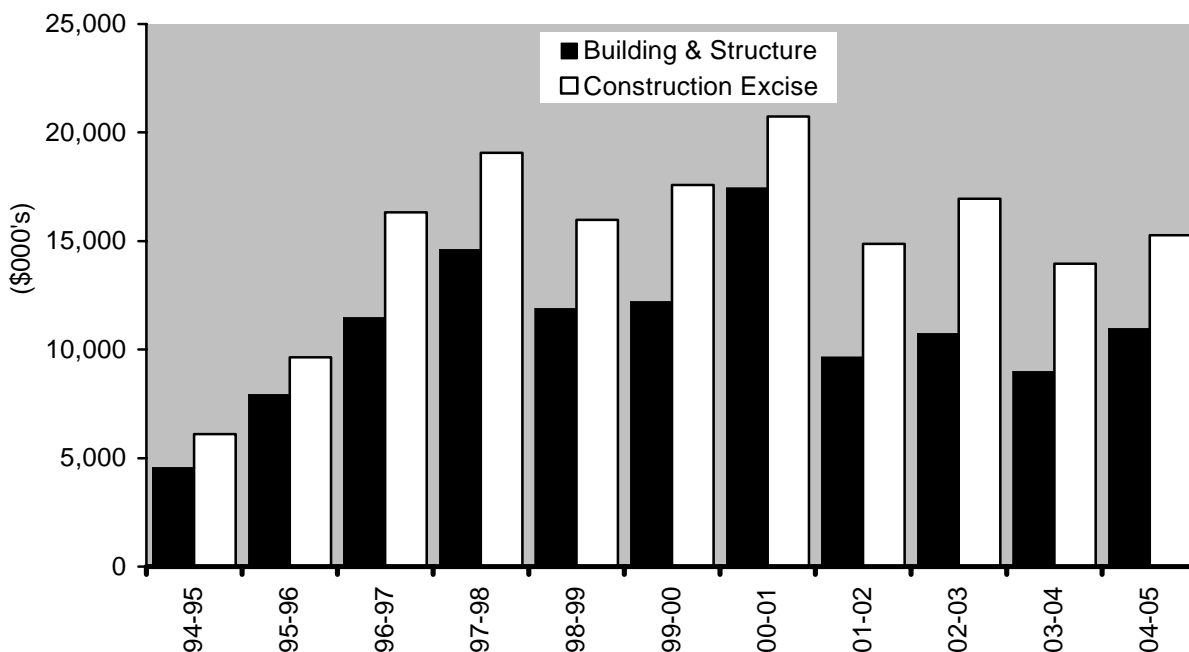
An increase of \$170,000 is recommended for the Convention Facilities Operation Subsidy. An increase of \$85,000 is recommended for the Convention and Visitor Bureau, and \$111,000 to the Cultural Grants, which included \$26,000 in rebudgets.

### Capital Improvement Program Funds

As reported in Monthly Financial Reports during the year, 2004-2005 collections in several of the major capital tax revenue categories exceeded both the estimates included in the modified budget and the prior year collection levels. Year-end collections in the Building and Structure Construction Tax category totaled \$11.0 million, which was \$1.8 million above the modified budget estimate of \$9.2 million, and was \$2.0 million (22.3%) above the \$9.0 million received in 2003-2004. With a similar trend, Construction Excise Tax receipts of \$15.3 million exceeded the modified budget estimate of \$14.2 million by \$1.1 million and were \$1.3 million (9.4%) above the 2003-2004 collection level of \$14.0 million.

The following graph displays the collection history of both the Building and Structure and Construction Excise Tax receipts over the past eleven years and illustrates the dramatic growth during the latter part of the 1990's. While collections have fallen from the peak in 2000-2001, they have remained relatively strong when considering the historical performance of these taxes.

**Construction Tax Revenues**



**Construction and Conveyance Tax** revenues, which are a significant source of funds for the Park and Community Facilities Development, Library and Fire capital programs, experienced phenomenal growth of 22.2% in 2004-2005. Actual receipts totaled \$46.7 million, significantly

## **STATUS OF SPECIAL/CAPITAL FUNDS (CONT'D.)**

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### **Capital Improvement Program Funds (Cont'd.)**

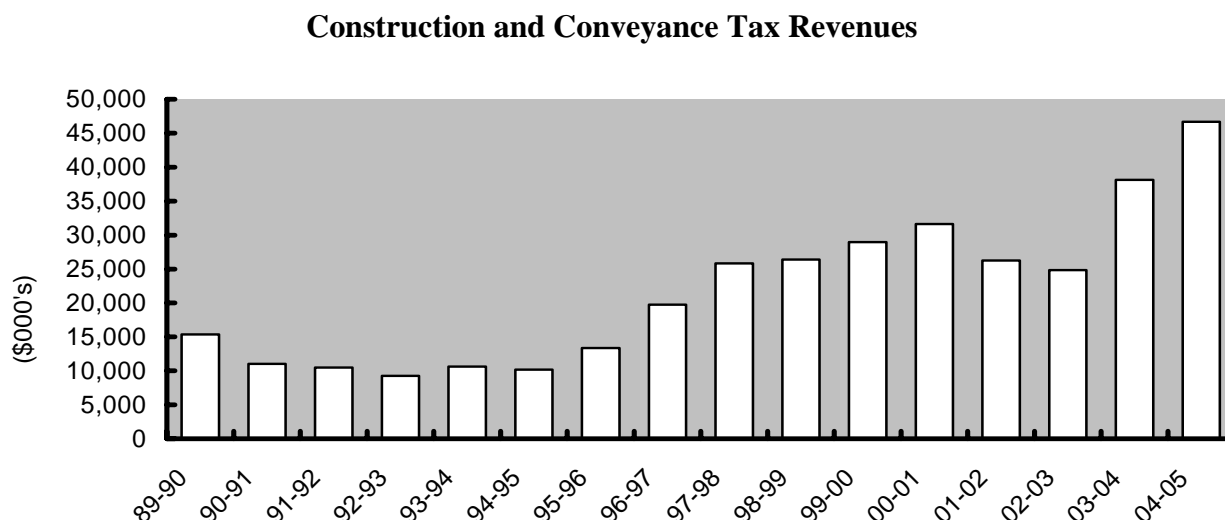
exceeding both the budgeted estimate of \$38 million and the 2003-2004 collection level of \$38.2 million. Collections in this category have been extraordinarily high in the last two years, with growth of 88% over this period due to the strength of the real estate market. The growth in the last two years was realized after two years of declines in 2001-2002 and 2002-2003. When the 2004-2005 budget was developed, it was assumed that there would be a slowdown in the real estate market that would result in lower revenue collections. This, however, did not occur as the home prices experienced significant growth and number of housing sales remained high. The number of real estate sales in San José increased 4% from the prior year, and the single-family median home price as of June 2005 of \$706,000 was 21% higher than the June 2004 figure of \$585,000.

The following graph displays the collection history of Construction and Conveyance Tax receipts. As can be seen, during the recession years in the early 1990s collections hovered around the \$9-11 million level for approximately five years. Following that recession, collections surged, with receipts reaching \$31.6 million in 2000-2001. After reaching this peak, collections dropped in both 2001-2002 and 2002-2003. The unprecedented growth of over 50% in 2003-2004 and an additional 22% in 2004-2005 ended this downward trend that was expected to continue until the economy recovered. Given the economic health of the region, the level of growth over the past two years has been extremely surprising and makes it very difficult to predict the level of activity in 2005-2006. We continue to believe that there is considerable risk that the housing market has entered a phase of unsustainable growth, similar to the stock market bubble experienced earlier this decade. This continues to be a hallmark of the California forecast produced by the prestigious UCLA Anderson Business School. If this finally proves to be the case, there should be some market corrections that would impact this category. Even given this risk, the 2005-2006 Adopted Budget estimate of \$20.0 million now looks overly conservative and obviously allows for an unlikely level of decline from prior year collection levels in this category. Based on the collection levels in recent years, therefore, it is anticipated that this revenue category can be adjusted upwards during the year.

## STATUS OF SPECIAL/CAPITAL FUNDS (CONT'D.)

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### Capital Improvement Program Funds (Cont'd.)



## LOOKING AHEAD

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Although San José and the surrounding areas continue to lag behind the rest of the State and the nation in terms of economic recovery, the results for the 2004-2005 fiscal year indicate that we have continued to successfully manage the resulting budgetary challenges, ending the year in a sound financial position. We can all take great pride in that achievement.

Looking forward it is clear that we face continued challenges in the immediate future. Prospects for a significant recovery in the local economy in the near term seem remote. Although we seem to have bottomed out from the freefall of the 2001-2003 period, nothing in the local economic indicators points to any significant change. In addition, recent developments in the national economic environment are giving us cause for concern. Rising oil prices and the prospect of continued increases in interest rates, along with mixed economic indicators have consumers worrying about a reduced potential for any substantial economic rebound in the near future. A widely followed gauge of future economic activity, The Conference Board's Index of Leading Economic Indicators, has fallen for three straight months reflecting a fall in consumer expectations even before the hurricanes hit the gulf region. The fall in consumer expectations was born out when the Conference Board recently released the Consumer Confidence Index for September, which indicated that consumer confidence plummeted to the lowest level in nearly two years.

Once again it is also worth reiterating our belief that the most crucial indicator of local economic health is and will continue to be the employment situation in the County, and although there are a few signs of slight improvement in this sector, one reason we remain very cautious about our

**LOOKING AHEAD (CONT'D.)**

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short term fiscal outlook is the generally sluggish employment situation which continues to plague our regional economy.

The City organization can, however, be justly proud that it has been able to maintain essential City services and programs in the face of ever shrinking resources. Again, it is a testament to the Mayor and City Council's leadership and steadfast commitment to sound fiscal planning that the City remains in a strong and relatively enviable financial position. I am very confident that it will be this same leadership, along with the combined dedication of policymakers and administration that will help us manage successfully through any difficult times that lie ahead.

As always, the Administration will continue to monitor the current year closely, reporting the City's fiscal status to the City Council through the Monthly Financial Report and Mid-Year Budget Review process.

DEL D. BORGS DORF  
City Manager

## HONORABLE MAYOR AND CITY COUNCIL

September 30, 2005

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I hereby certify that there will be available for appropriation in the designated funds and in the amounts as listed below in fiscal year 2005-2006 monies in excess of those heretofore appropriated therefrom:

General Fund	\$	34,477,134
Airport Capital Improvement		26,337,112
Airport Maintenance and Operations		1,227,129
Airport Passenger Facility Charge		3,514,539
Airport Renew & Replacement		6,905,649
Airport Revenue		12,092,365
Airport Revenue Bond Improvement		19,808,504
Airport Surplus Revenue		4,700,000
Anti-Tobacco Master Settlement Agreement		1,016,571
Benefits		268,055
Building & Structure Construction Tax		9,972,310
Business Improvement District		143,798
Civic Center Construction		3,656,908
Civic Center Improvement		10,560,284
Civic Center Parking		424,306
Community Development Block Grant		3,453,077
Community Facilities District 1		45,912
Community Facilities District 2 and District 3		88,835
Community Facilities Revenue		1,678,722
Consolidated Water Utility		73,298
Construction & Conveyance Tax - Council District 1		382,970
Construction & Conveyance Tax - Council District 2		319,109
Construction & Conveyance Tax - Council District 3		834,410
Construction & Conveyance Tax - Council District 4		366,741
Construction & Conveyance Tax - Council District 5		174,475
Construction & Conveyance Tax - Council District 6		419,496
Construction & Conveyance Tax - Council District 7		434,531
Construction & Conveyance Tax - Council District 8		257,341
Construction & Conveyance Tax - Council District 9		115,907
Construction & Conveyance Tax - Council District 10		370,086
Construction & Conveyance Tax - Central Fund		226,840
Construction & Conveyance Tax - City-Wide		3,566,392
Construction & Conveyance Tax - Communications		670,142
Construction & Conveyance Tax - Fire		1,175,130
Construction & Conveyance Tax - Library		1,708,274
Construction & Conveyance Tax - Parks Maintenance		288,179
Construction & Conveyance Tax - Service Yards		1,706,885
Construction Excise Tax		12,956,298
Convention & Cultural Affairs		8,244
Dental Insurance		230,378
Development Enhancement		486,770
Economic Development Administration Loan		37,440
Emma Prusch		725
General Purpose Parking		3,749,586
Hayes Mansion Phase III		717,061
Housing Trust		385,637
Ice Centre Revenue		1,299,120
Integrated Waste Management		500,862

Interim City Facility Improvements	\$ 116,304
Library Benefit Assessment District	2,159,869
Life Insurance	50,535
Low & Moderate Income Housing	10,326,562
Maintenance Assessment District 1	101,586
Maintenance Assessment District 9	22,794
Maintenance Assessment District 10	20,779
Maintenance Assessment District 11	9,604
Maintenance Assessment District 15	200,204
Maintenance Assessment District 18	5,061
Maintenance Assessment District 20	5,926
Maintenance Assessment District 22	793
Major Collectors & Arterials	85,091
Municipal Golf Course	306,544
Parks & Recreation Bond Project	424,416
Redevelopment Agency Capital Projects (City side)	2,706,951
Residential Construction Tax Contribution	499,562
Sanitary Sewer Connection Fee	1,183,922
Sewer Service & Use Charge	1,450,369
Sewer Service & Use Charge Capital	7,623,467
SJ-SC Treatment Plant Income	2,191,645
SJ-SC Treatment Plant Operating	1,461,231
State Drug Forfeiture	11,261
Storm Drainage Fee	460,156
Storm Sewer Capital	638,957
Storm Sewer Operating	1,359,451
Subdivision Park Trust	10,474,443
Transient Occupancy Tax	373,860
Underground Utility	1,506,997
Vehicle Maintenance & Operations	1,299,753
Unemployment Insurance	80,393
Water Utility Capital	206,011
Workforce Investment Act	39,005

Larry D. Lisenbee  
Budget Director